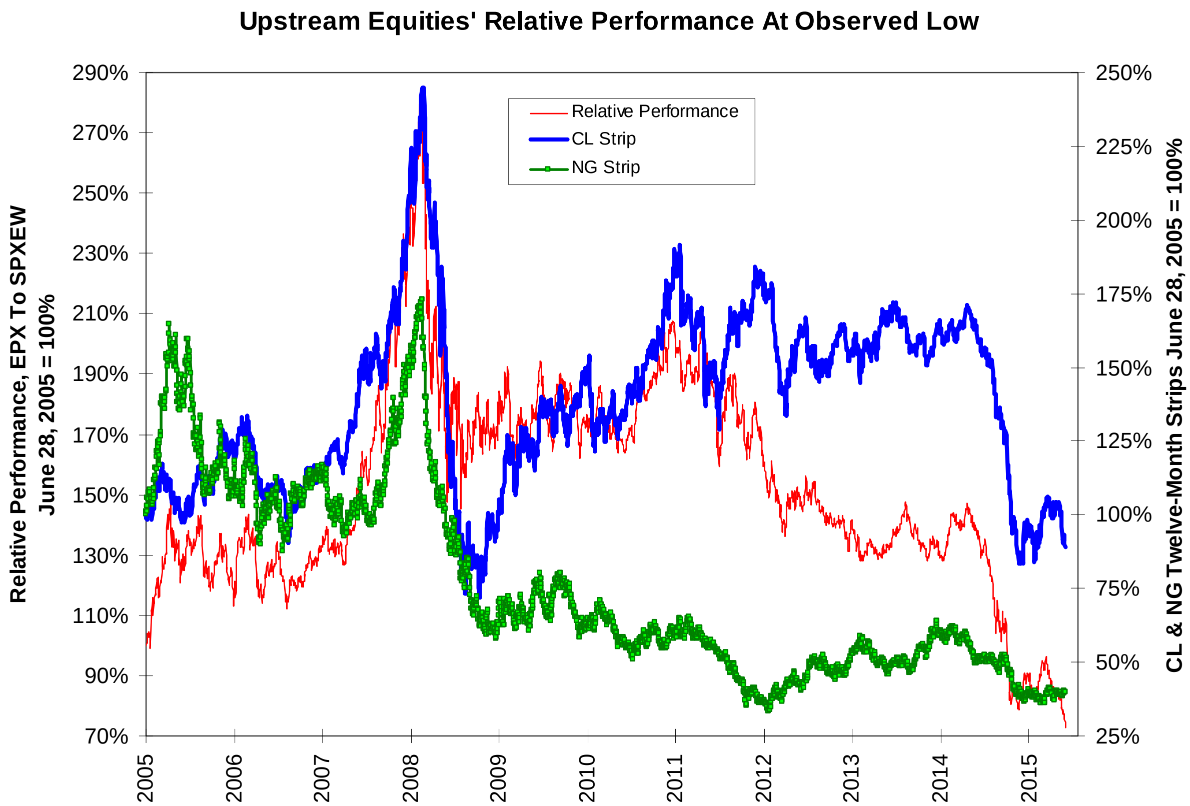
Energy Upstream Up Creek

I cannot prove it, which makes it better for rhetorical purposes, but if a new Jed Clampett found crude oil today, he would be better off selling it off to a master limited partnership and perhaps swapping his interest for a stake in a refiner. Then and only then should he load up his truck, move to Beverly Hills and start writing large checks to politicians who excoriate people capable of writing large checks. It is the American Way.

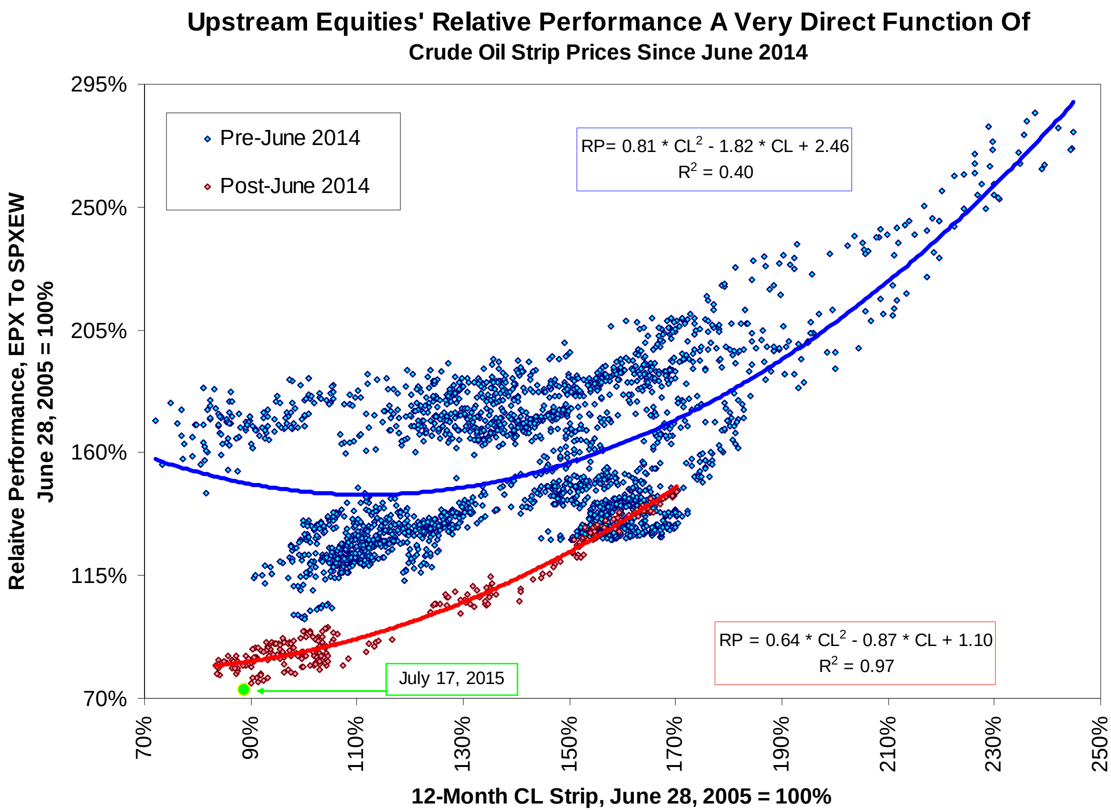
Let's take a look at the SIG Oil Exploration & Production index (EPX), an equal-weighted index of 21 "upstream" or exploration & production firms involved with the oil and gas extraction business. This index can be compared to the S&P 500 equal-weighted index for a relative performance measure.

As equity markets look ahead, we should use twelve-month strip prices instead of front-month futures prices to eliminate seasonal effects and the pronounced distortions of the forward curves we have seen in recent years. The results would be even more distorted if we used total returns for the Dow Jones-UBS crude oil and natural gas indices instead of the strip prices as proxies for the commodity prices. What we see in the chart below should not surprise anyone. The relative performance of the EPX is at an observed low since the data became available at the end of June 2005.



The 21.8% rebound in relative performance between early January and the end of April reflected the market's belief lower crude oil prices would lead to production cutbacks. This response was misguided on two levels. Not only have prices turned lower, but any downturn in upstream actively would have affected the industry's profitability negatively.

The increased dependence of upstream relative performance on twelve-month crude oil strip prices is highlighted when we map the two series split at June 24, 2014, the start of crude oil's massive downturn in the second half of 2014. The relationship post-June 2014 has an extremely robust r-squared or percentage of variance explained, of 0.97. If crude oil prices remain in their downtrend, the relative performance of the upstream sector will continue to decline and the financial stresses on debt-financed firms will increase.



Both the upstream side of the industry and investors in both energy debt and equities made a losing bet on the proverbial "other guy" taking the losses. Most negative-sum games in investing involve panic selling; the shared idea of being able to get out first in a downturn. That usually results in a market crash. This negative-sum game involved investors financing excess capacity and postponing the inevitable.

The industry will rebound eventually, but only after a shakeout of the weaker players via consolidation and assumption of debt or an upturn in bankruptcy. Should you step up to the plate now? No; remember, the early bird gets the worm but the second mouse gets the cheese.